Don't blame energy speculators for rising cost of crude oil

By Frank A. Wolak

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The price of a barrel of oil has more than doubled in the past year and a half, from $60 in early 2007 to a high of $142 earlier this summer. This has led to a search for someone to blame for this price increase and for government policies to reduce oil prices.

The actions of energy traders, more pejoratively known as speculators, are being targeted by Ralph Nader, the chief executives of the major domestic airlines and many members of Congress as a major cause of this price increase. However, data from world oil market demonstrates that it is unlikely that speculators have had a noticeable impact on world oil prices.

House Speaker Nancy Pelosi, D-San Francisco, recently called on President Bush "to draw down a small portion" of the U.S. Strategic Petroleum Reserve to reduce oil prices. But this is unlikely to have a discernible effect on world oil prices.

Oil is a relatively homogenous commodity traded in a world market with a demand of 85 million barrels a day, of which 25 percent is consumed by the United States. The demand for oil is insensitive to changes in the price of oil, particularly in oil-producing countries, where its use may be subsidized. Recent research suggests a 10 percent increase in the price of oil would reduce world demand by no more than 1 percent.

Speculators are accused of increasing the price of oil by taking large financial positions in oil futures markets. But these bets on the future price of oil have no impact on the current price of oil if the current demand equals the current supply, meaning there is no net change in inventories of oil.

According to the U.S. Energy Information Administration, commercial inventories of oil currently held by the major industrialized countries are below their five-year average. That means consumers are willing to purchase all available supply and run down inventories at the current high price. Given that market outcome, the behavior of speculators cannot be inflating the price.

What would speculators have to do to increase the world price of oil by $25 relative to a $100 baseline? They would need to buy and put into inventory approximately 2.5 percent of world demand, or approximately 2.125 million barrels a day. Over the course of a year, this would amount to storing 775 million barrels, which is the current amount in the our country's Strategic Petroleum Reserve.

Applying this same logic to Speaker Pelosi's recommendation to draw down a small portion of the reserve--say 100 million barrels over the course of a three-month period--this 1-million-barrel-a-day increase in supply implies at best a three-month-long $12.50 reduction in the price of oil relative to its current price of $125.

However, according to the Energy Information Administration, world inventories of oil held by industry and government are on the order of 7 billion to 8 billion barrels. So a more likely outcome of withdrawing 1 million barrels a day from the government's reserves for three months is that privately held inventories would increase one-for-one, and world oil prices would be unaffected.

Although energy traders are a convenient scapegoat for the current high price of oil, the numbers just don't add up for their actions to have any significant impact on market prices. A strong world demand, not the actions of speculators, is responsible.

But releasing a small amount of oil from the U.S. reserve may still make sense. Given historically high prices--and the great need for government revenues--this may be a fortuitous time to sell oil and take advantage of the market.

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